DOW THEORY LETTERS INC.

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THE MARKET: Expert opinion is increasingly (actually extraordinarily) divided as summer ends. Some analysts such as E. George Schaefer expect gathering strength into fall and even into 1966 as the boom heats up and as a record 7.2 million short sellers are driven to cover. Others such as Joseph Granville expect intermediate-term strength with an accompanying testing of the 1965 Industrial high of 939.62. Still others, for instance Garfield Drew, allow for further indeterminate strength, though Drew will view any such potential strength as coming within the framework of a long-term top.

On the bear side analysts such as Anthony Gaubis warn that "both Wall Street psychology and the action of the stock market during this week have been uncomfortably reminiscent of developments during August of both 1937 and 1946" (my note: both these periods preceded violent but relatively short-lived collapses). James Dines notes that even though the Dow broke out at 897 and is in position to assault the high, "our fear of a drop with even less warning than the June decline prompts us to let you 'pass this rally by'." Don Worden's big-block studies put his long-term indicator at 73 (the danger level is anything below 80), and thus he views the current action as part of a major market top.

There is no doubt but that the market itself is reflecting the confusion and diverse opinions now being expressed by Wall Street's best minds. The D-J Rail Average (which "topped out" in October, 1964) and which led the market to the June lows, is currently displaying superb strength. In fact, over the past few weeks the carrier Average (although still well below its 1964 high of 224.91) has climbed to a new 1965 high. It is the Industrial Average which has been braking the recovery.

On August 4 Industrials confirmed the Rail strength by bettering their July high of 883.23 (see chart 1), but the upside penetration by Industrials has (so far) lacked either force or conviction.

On August 18 Industrials struck a recovery high of 894.35, thereby rising to within a point of their 30-week moving average (chart 1). Over the next few days Industrials backed away from this critical area despite continued strength in Rails and despite continued support from the general market as measured by the (rising) advance-decline ratio. Where does the superior vision lie, with the rising Rails and the rising market breadth — or with the hesitation and caution of the "blue-chip" D-J Industrial Average?

Despite many "expert opinions" to the contrary, I will remind subscribers that from a Dow Theory standpoint neither Average possesses greater predictive ability than the other. Thus there have been instances (for instance, July-August, 1957) when unconfirmed Rail strength marked the top of a move, and there have been other times (such as October, 1962) when superior Rail action proved to be the signal for a new bull movement. The same may be said of Industrials. For instance, the refusal in 1957-58 by Industrials to confirm a declining Rail Average led to a major rise, whereas the superior (but unconfirmed) strength of Industrials in late-1959-early 1960 proved to be completely deceptive. The one certainty is that a "parting of the ways" by the two Averages leads to reversals. There have been few times in the history of the stock market when a single Average made sustained headway without confirmation from the other component.

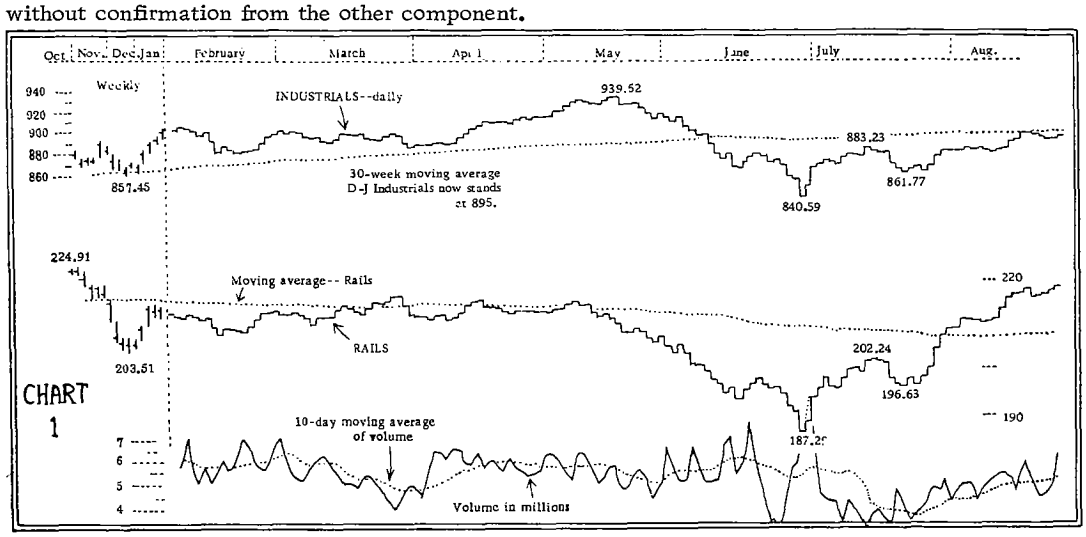
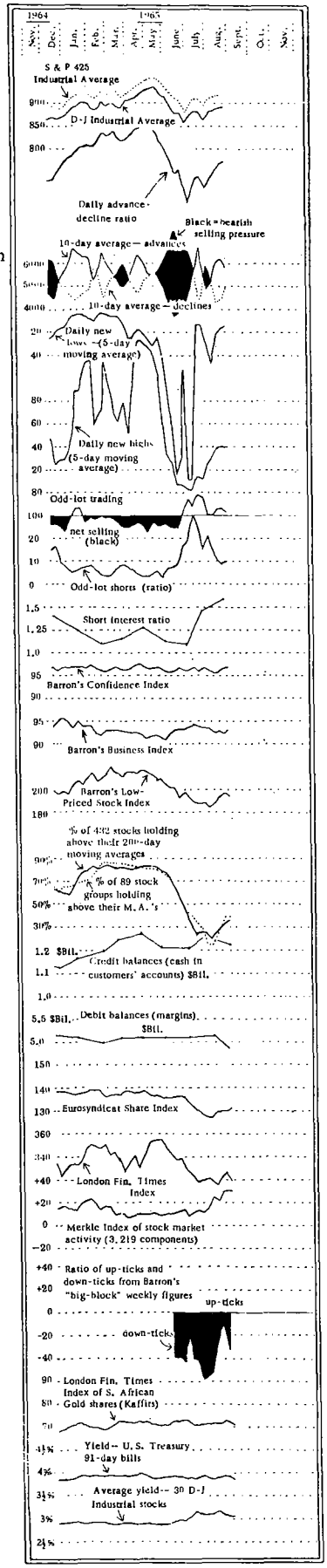


CHART 1


1964
1965
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving average)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield -- U.S. Treasury 91-day bills
Average yield -- 30 D-J Industrial stocks

Conclusion: The primary trend is bearish, the secondary trend turned bullish when the Averages bettered their July peaks. Dow Theorists would be happier if the two Averages now pushed out on volume, but so far neither the Industrial rise nor volume since the July peaks have been impressive.

THE COMPOSITE CHART (Page 1) shows the two leading industrial averages climbing "in gear" with the A-D ratio. The 10-day average of advances now appears to be "rolling over," and such action often precedes a slide in the Averages (check past history of this chart). In the current August 23 issue of Barron's (Page 10) there is an article about daily upside and downside volume as measured by the electronic Quotron. I have been keeping these same Quotron statistics for some time, and I have considered including them in the Composite Chart. The article in Barron's suggests keeping the Quotron figures as a 10-day average of upside and a 10-day average of downside volume (exactly as we keep advances and declines). The author of the Barron's article notes "...the tendency of volume to lead price shows strongly in the peaks of Up Volume, which appears well before peaks in the DJIA. Second, there is a general tendency for Up Volume to decline and Down Volume to rise before a decline in the DJIA. In other words, a new high in the Averages which is not confirmed by a higher peak in the Up Volume is a sign of weakness." This is correct, and this same observation can be made of our averages of advances and declines. In fact, the advance and decline lines as shown in the Composite Chart so nearly correspond with the Quotron volume lines that I feel inclusion of the Quotron volume would be superfluous. It is perhaps significant that the July peak in both Quotron Up Volume and our advances was above the recent August peak. Thus, although the DJIA is now above the July peak, neither Up Volume nor the advance line as seen on the Composite Chart have confirmed. This is an element of weakness.

INTERNATIONAL PICTURE: Letter 296 touched upon the gathering economic storm which has settled over Japan, a storm which was foreshadowed by the two-year collapse in the Japanese securities market (formerly known as "the people's market"). Now from the August 17 New York Times comes an article entitled "Dog Days in London," and the piece goes on to describe the slump which is taking place on the British stock exchange. "These are dog days in the financial district. Business has slumped seriously this year and so have profits of the brokerage and jobbing firms.....The mood on the exchange floor has changed. Visitors to the exchange a year or two ago were struck by the light-heartedness on the floor. A favorite pastime, for example, was throwing bits of paper around like cricket balls. Now those on the floor seem too depressed even for this. Some statistics show the magnitude of the slump. The exchange does not report daily volume but does supply a monthly figure on the value of all sales. In July this was 1.2 billion pounds, compared with 1.5 to 1.7 pounds earlier in the year and late last year."

Following the market's lead, the British economy is now beginning to show evidence of Labor's policy of "planned deflation," a policy dictated by the need to make Britain more competitive and thereby protect the pound. A number of large manufacturers are cutting back production as consumer buying falls off. The unemployment rate jumped 20% in mid-August. The test of Britain's will to protect its currency has arrived.

The question is, will the "fat cat" British be willing to stand the pain of deflation? The answer is very much in doubt, and as unemployment rises and as the British economy slumps further the pressure will be on Labour to "ease up or get out." It is going to be a fascinating period, but already we are seeing signs of revolt. For instance, last week the leaders of five unions issued a "declaration of dissent" to Mr. Wilson's "guidelines" of 3 to 3½% annual wage increases. Even the Transport and General Workers Union (the most powerful union in England) has attacked the guidelines. And the needed results have yet to appear. For instance, the latest (August 21) London Economist shows British wages up .9% in the last three months, retail prices up .6% in the last three months, export prices up 2% in the last year!

Monetary expert Alden Wells in his latest report (Palisades Park, N. J.) writes: " A year ago (British) reserves were $2.7 billion against which there were no borrowings. The loss for the year appears to be in excess of $3 billion....we estimate that reserves may be currently approaching minus one billion." If Mr. Wells' reckoning is correct (and I have no reason to doubt his figures) then Britain is now broke, and nothing stands between it and bankruptcy but an actual move by its creditors. Whether the "move" will be made depends on many things including forthcoming developments in the British competitive struggle, willingness of the U. S. to make more loans available to Britain, developments in the British balance-of-payments picture, and the willingness of the British people to tighten their belts.

Meanwhile, back in the U. S. the repercussions are beginning to be felt, and one of the reactions is a slump in the U. S. Treasury bond market (see news clip from August 22 Associated Press report). If Britain really means to defend the pound, then one of the measures taken will probably be even higher interest rates. Higher rates in Britain will almost certainly mean higher rates in the U. S. and the sensitive Treasury bond market is already "protecting" itself via lower prices and rising yields. For over a year now this writer has been questioning the "more inflation" thesis. We may be having inflation but buyers of Treasury bonds can currently purchase selected issues at the most attractive prices in five years (and I do not advocate such purchases now). The fact is that deflation in the bond markets is providing the biggest bargains (in terms of yields) since 1960 with some bonds at record yield highs of above 4.25%.

Treasury Bond Yields Advance To 5-Year High

NEW YORK (AP) — U.S. Treasury and corporate bond prices eroded last week. Municipal bond prices generally were firm.

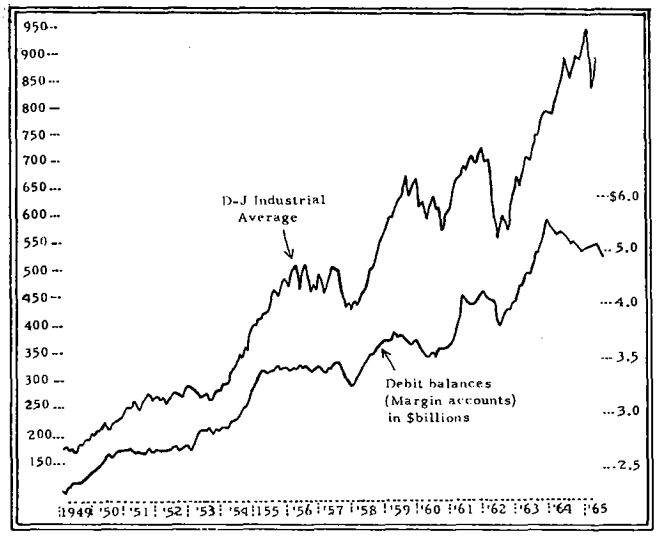
It was the fourth consecutive week that Treasury bond prices declined, bringing their yields up to a five-year high.

Daily new highs are rising, but they too are sluggish, having moved only to the 40 area. Odd-lotters refuse to step up buying on the advance, and this is an item of strength. Perhaps the strongest single technical factor in the current market is the short interest ratio which is now 1.67, a high for the year. The percentage of stocks holding above their moving average is still 36% — not a strong showing yet. Debit balances (bearish) are covered in a later section. The London stock average is again reflecting the strains of Labor's planned deflation. The Merkle Index is clearly bullish at around 30. The big-block ratio for the latest week was minus 33 with 45 big blocks (the most for any week yet) traded; 3 blocks on up-ticks and 18 on down-ticks. Thus we have continuing big money distribution.

For the intermediate-term standpoint I list the bullish items as follows: (1) The secondary upward zig-zags in the Averages. (2) Odd-lots. (3) Short selling ratio. (4) The performance of the A-D ratio. Bearish factors include: (1) Declining trend in debits. (2) Lagging Utility Average. (3) New 1965 low on the D-J 40 Bond Average. (4) Continuation of big-block down-ticks. (5) The lack of "good days" as described in Letters 291 and 295 (send self-addressed stamped envelope for these). In the 43 trading days since the June lows, the market has produced one "bad day" and only four scattered "good days." Four good days out of 43 (a good day being a day when all three Averages, volume, advance-decline and new highs are up) is a very slim number for any rally, and it is a negative factor in this advance.

Conclusion: The market does not look bad, but what bothers me is that the bearish factors in the market tend to be the sophisticated indicators, the ones that tend to measure what the "big money" is thinking. Bonds and utilities tend to be sensitive to money rates. Does the market expect another rise in the British bank rate and a protective rise in our own discount rate? Another rise to say 4½ or 5% in our own bank rate would be "dynamite" and would rock the stock market on its heels. The bond market would be hit hard, and money would be transferred immediately from savings banks and demand deposits to Treasury bills, thus immediately affecting bank reserves (adversely). Do the lagging Utility, Bond, and "blue chip" D-J Industrial Average suspect a forthcoming rise in interest rates? They almost act as if they do (see profile of Utility Average in your Wall Street Journal). What to do — I'm leaving this advance alone; they're too many things about it that are not checking out satisfactorily.

TRAIL OF THE SPECULATOR: One of the valuable studies which has been developed is that which deals with the trend of debit balances (better known as margin accounts). The definitive work on this subject was published a few years ago by my friend Dr. Sloan Wilson ("The Speculator and the Stock Market" available for $5.95 at this office).



In this book Wilson documents his thesis that the speculator is the trend-setter in the stock market. The professional speculator tends to be first to enter during a new bull market (or a new major advance) and the first to exit at the inception of a primary bear market (or an important reaction). But how can we follow the path of the speculator? Dr. Wilson has termed the margin account (the debit balance in the parlance of Wall Street) as "the most important tool of the speculator." Thus, where the amateur is liable to use 100% cash in his transactions, the speculator prefers to use as much borrowed money or margin as possible. It therefore follows that the action of speculators can be traced by the trend of the debit balances on the N.Y.S.E. (debit figures are released each month by the Exchange).

Dr. Wilson discovered a remarkable fact. At the start of every bull market the total debit balances were at an extremely low level. Then as the primary bull trend continued higher, the total margin accounts increased. Finally at or near the bull market top the margin accounts turned down. As the bear market continued the margins continued to contract. At the ultimate bear market bottom the margin accounts shrunk drastically — to or even below the level at which they stood when the previous bull market began!

In other words, in every bull market there comes a time (regardless of what is happening in the stock market) when the speculator wants to get out and on the sidelines. Furthermore, the ensuing bear market will not end until the margin accounts are reduced to or below the level which existed when the preceding bull market began. At the extreme lows we can say that the speculators' margin accounts are in disuse. The speculator is out and waiting for the new bull market to begin.

A brief history of previous cycles might prove interesting. During the 1921-29 bull market the expansion of brokerage loans (comparable to debits) increased from $950 million to $8.5 billion, an increase of around 900%. Brokers' loans hit their peak in September, 1929, simultaneously with the peak in the Industrial Average. The bear market of 1929-32 took debit balances to $690 million, a low level indicating drastically reduced margin accounts.

In the 1932-37 bull market debit balances rose from $690 million to a peak of $1.55 billion in March, 1937 (an increase of 125%). Debits again topped out simultaneously with the Dow in 1937. The bear market of 1937-38 took debits to $760 million — back to the level of 1932.

The 1942-46 bull market started with debits at an extreme low of $490 million. By June, 1945, debits had risen to $1.3 billion (up 145%), but this peak proved to have arrived 11 months before the July, 1946 peak in the stock market. By May, 1947, debits had dropped back to $466 million, a record low. Thus the debit expansion of the previous bull market had again been wiped out by the bear market which followed.

But what about the current situation? From the March, 1949, low of $466 million, speculators increased their debit balances to the November, 1963, peak of $5.6 billion. This represented a rise of about 1200%. In looking over the entire debit-stock market relationship, three facts are outstanding at this time. First, the fantastic percentage of increase in margin accounts since 1949. Second, the fact that debits (see chart) appear to have "topped out" and turned down 22 months ago. Third, the latest figures (released on August 17) show that debit balances dropped $252 million in the month of July (1965), taking the debit balances to their lowest level since May, 1963. (The trend of debits and the Industrial Average are plotted on the accompanying chart and should be studied carefully).

CONCLUSIONS: It is fairly certain that the debit balances "topped out" 22 months ago in November, 1963. The new July, 1965, low in the debit balances offers proof that the trend of the debit balances continues down. The question might be asked, "How long can the market hold up in the face of a continuing decline in the debit balances?" The market has already broken all preceding records by establishing a peak for Industrials (assuming that May, 1965 high was the peak) 18 months after a peak in the debit balances. And with debits at new lows last month, it would appear that the debit studies offer further ammunition to those who warn that this market is entering increasingly dangerous territory.

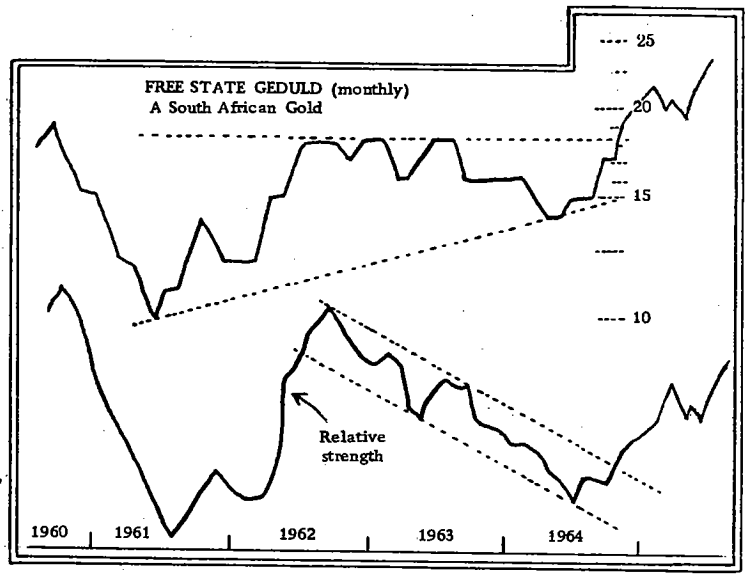
STOCKS: Traders Research (1431 Pearl St., Alton, Ill.) list the following as the strongest of 46 groups: (1) Gold, (2) Sulphur, (3) Airlines, (4) Aircraft, (5) Textiles. Bottom five on the list are (42) Tobacco, (43) Building Supply, (44) Cosmetics, (45) Paper, (46) Amusements.

Over the past few months I have been debating whether it was worth while suggesting speculative positions for the current rally, and I was thinking in terms of a possible run to a "double top" in the Dow (see Letter 295, Page 1). Although four Aircraft issues were

suggested in Letter 295 and four Dow stocks were suggested in Letter 294, I was in general more interested in subscribers unloading on this advance than I was in jumping in here for a speculative ride. I still feel the same way.

Happily, many of the gold shares which have been repeatedly recommended here have increased substantially in price. This appreciation has served to calm the nerves of those readers who insist upon making money on every upward swing in the market. One of the problems which readers have had to face with South African golds is the scarcity of available information and the almost complete absence of charts. I have tried to overcome these problems by including information and occasional charts covering selected issues.

Back in Letter 294 I included a rare chart of Free State Geduld, a stock which was strongly recommended in Letter 270 (price 17). These line charts of the Kaffirs are practically non-existant, and in many cases I have only been able to run them back a few years (on a monthly basis). The Free State chart goes back monthly to mid-1960, however, and the strength of this huge ascending triangle formation is plain to see. Those who purchased Free State earlier this year are now showing about 35% gain on their money plus 8% in dividends.



On January 7 (Letter 276) I recommended purchase of Western Deep Levels "A" which was then selling at 10. This fabulous gold equity (which has been repeatedly recommended since then) has now risen to 13½ which means an appreciation of 35% (plus 3% for yield). The accompanying chart shows the 1961-63 yearly range for Western Deep and the beginning-of-each-month "bid" price for Western since 1964. The strength of this issue requires no comment.

The South African Government does not tax the mines until all pre-production capital expenses have been recovered. This means that Western Deep (which only started producing in March, 1962) will have a number of years ahead of it before it starts paying taxes, and this should allow for a liberal dividend policy. Only the "A" shares now pay dividends, but probably by next year the "B" shares (selling for slightly less than the "A") will be on the same basis and will be exactly the same as the "A" shares.

I continue to recommend Western Deep (even at this price), and since so many of my subscribers now own substantial quantities of this issue, I have decided to include an article from the January, 1965 special S. African supplement of the New York Times which I think will be of particular interest.

THE NEW YORK TIMES.

Vast Source of Gold Is Opened in South Africa

Western Deep Mine Breaks Through 9,345 Feet Down

Special to The New York Times

JOHANNESBURG, South Africa—The Western Deep Level fold mine, destined to be the world's deepest and largest gold mine, achieved a development tunnel breakthrough 9,345 feet below the surface last month, opening a vast new phase of development of the mine.

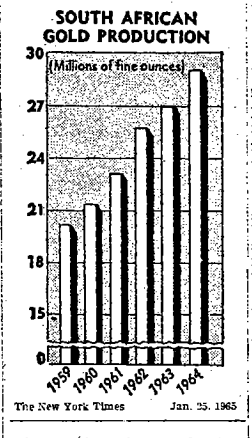
In the next 60 years the mine is expected to produce gold valued at more than $2.2 billion.

The estimated output would almost triple the present total annual output of the South African gold mining industry, which already produces about 70 per cent of the non-Communist world's gold. The 1964 output should be about 29,000,000 ounces, almost 2,000,000 more than the previous year.

The breakthrough at Western Deep Levels after 22 months of patient survey work and underground progress continues the expansion of South Africa's gold industry.

The birthplace of the industry, the Central Rand—where Johannesburg is today—now yields less than 6 per cent of South Africa's total.

Although costs are high and marginal mines are suffering, the output of this old goldfield is still one of the greatest in the world.



The fields developed since World War II—the Orange Free State, the Far West (which contains Western Deep Levels), Rand, Evander and Klerksdorp—account for more than 76 per cent of South Africa's gold production.

The glitter of South Africa's mining is enhanced by its increased production of diamonds. The value of sales of South African diamonds in the first nine months of 1964 was more than $280 million, a new high.

Harry Oppenheimer, chairman of De Beers, said last month that the increase was partly a reflection of recent rises in the prices of gem diamonds, but that the demand was "in better balance" than it has been for years.

Regular production on a considerable scale is beginning to be returned by the Marine Diamond Corporation, the diamonds-from-the-sea project working off the South West Africa Coast, Mr. Oppenheimer added.

Coal and uranium are also significant items in South Africa's mining industry.

Its production of salable coal is more than 46,000,000 tons. Coal may yet prove to be South Africa's most valuable mineral asset. The known deposits have been conservatively estimated at 75 billion tons.

The future of the uranium industry, at present worth almost $168 million a year, holds great promise.

Copper is also going to play a large role in South Africa's mining industry soon. By June, 1966, a $103.6 million program will have brought the Palabora Copper Mining Company into production. The plant will yield 33,000 tons of copper ore a day. It will have a smelter to produce 80,000 tons of anode copper a year.

Yield Is Expected to Triple Country's Annual Output

FOREIGN EARNINGS: Few investors are aware of what a large part foreign earnings play for many of America's Industrial giants. For instance (thanks to Indicator Digest) the following percentages represent earnings from foreign sources: Goodyear 35%, Colgate 85%, Gulf Oil 30%, Int. Harvester 60%, Int. Tel. 64%, Proctor & Gamble 30%, Socony 50%, Standard of Cal. 45%, St. of Jersey 60%, Texaco 35%, Woolworth 42%. With foreign economies now contracting, this could be the reason for weakness in many such stocks. In fact, of all the above mentioned stocks only Socony and Standard of Cal. are near their highs while the rest look bearish (last week Standard of Jersey, Int. Harvester, and Colgate broke to lows for the year).